SEWARD & KISSEL LLP

ESG Overview for Asset Managers

March 18, 2020

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SEWARD & KISSEL LLP

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Overview

95% of millennials are interested in sustainable investing, or investing in companies or funds that aim to generate market-rate financial returns, while pursuing positive social and/or environmental impact. Two-thirds of Millennials are now adopting at least one sustainable investing activity, and 91% of them have expressed interest in an impact report that tracks social and environmental return on their sustainable investments.

- 2019 Morgan Stanley Institute for Sustainable Investing Survey

Bank of America Merrill Lynch predicts that in the next 20 years, women, high net worth individuals and millennials could pour approximately $20 trillion into ESG investments in the United States.

- 2019 Bank of America Merrill Lynch Global Research Study

Overview

Callan Institute

7th Annual ESG Survey (2019)*

*Based on 89 "institutional investor" responses. For this survey, ESG factors include socially responsible investing (SRI, including divestment), sustainable investing, responsible investing, impact investing and other associated terms.

Overview

In 2018, institutional investors, money managers and community investing financial institutions that reported considering ESG issues in their investment research, analysis and decision-making represented portfolios totaling $11.6 trillion, a 44% increase, compared to $8.1 trillion across portfolios reported in 2016.

Registered investment companies, such as mutual funds, variable annuities, ETFs and closed end funds, that incorporate ESG investing criteria account for 22% of the $11.6 trillion in money manager ESG assets.

The ESG AUM of registered investment companies grew from $320 billion in 2010 to $2.6 trillion at the start of 2018, a more than eight-fold increase.

Institutional investors and money managers that file or co-file shareholder resolutions on ESG issues represent $1.8 trillion in assets under management.

US SIF Foundation 2018 Report on US Sustainable, Responsible and Impact Investing Trends

Overview

Recent Developments

- State Street
  - "We believe that increasing material ESG issues is good business practice and essential to a company's long-term financial performance – a matter of value, not values."
- BlackRock Letters (to CEOs and Clients)
  - "Our investment conviction is that sustainability and climate-integrated portfolios can provide better risk-adjusted returns to investors."
  - "Currently, every active investment team at BlackRock considers ESG factors in its investment process."
- Allocators
  - We understand that a manager's use of ESG factors in its investment process is a factor taken into account by allocators in selecting managers
- Fund of Funds
  - We understand that large institutional fund of funds managers have dedicated resources and teams who are similarly reviewing underlying fund managers' ESG policies as part of their routine diligence

Overview

What is ESG Investing and How Did We Get Here?

- Prevailing Modern Definition of ESG
  - Incorporating environmental, social and corporate governance factors into the investment decision-making process

Environmental	Social	Governance
Climate change	Employee health & safety	Board independence/diversity
Greenhouse emissions goals	Diversity & inclusion	Executive compensation
Carbon footprint	Ethical supply chain sourcing	Shareholder rights
Renewable energy	Privacy/data security	Separation of Chair and CEO
Sustainable initiatives	Human rights	Business ethics

- Traditional Socially Responsible Investing ("SRI")
  - Negative screens; principles-based investing
  - Often tailored to the requirements of a specific client
- Economically Targeted Investing ("ETI")
  - State and union pension plans; targeted collateral benefits (job creation and affordable housing)
  - Mixed performance results

Key Considerations for Asset Managers

Increased Focus on ESG

- Investor Focus
  - Allocators' review of managers' ESG policies and procedures
    - These policies are included as part of the analysis and review of the manager
    - A manager's use of ESG factors in its investment process is a factor taken into account by allocators in selecting managers
  - Evolution of side letter requests
- U.S. Regulatory Focus
  - SEC Office of Compliance Inspections and Examinations 2020 Exam Priorities
    - OCIE's 2020 Exam Priorities highlight the SEC staff's interest in the accuracy and adequacy of disclosures provided by registered investment advisers offering clients new types of strategies, such as those focused on sustainable and responsible investing
  - SEC Sweep Exam
    - Recent SEC sweep exam related to asset managers' use of ESG considerations in their investment process

Key Considerations for Asset Managers

- Developing an ESG Policy and Procedures
  - Aspirational policies will not be sufficient going forward
  - Include ESG definition
  - Tailored to investment philosophy and strategy
  - Bespoke – no "one-size-fits-all" approach
- Incorporating ESG into an Asset Manager's Investment Process
  - Review current investment and research process in light of ESG factors and consider implementing enhancements
  - Formalize and memorialize the steps taken to reflect the ESG considerations incorporated into the asset manager's investment decision-making process (e.g., investment committee minutes and investment memos)
  - Expense and resource considerations
    - Difficulty of obtaining consistent and accurate data points on portfolio companies and ESG metrics since there is no standardized ESG approach
    - Allocation of asset manager's resources
  - Consider use of third-party service providers versus internal resources and/or some combination thereof

Key Considerations for Asset Managers

- Legal/Compliance Considerations
  - Full and fair disclosure in the asset manager's fund offering documents/prospectus, Form ADV, and other documents, such as due diligence questionnaires and marketing materials
    - Additional issues to review if the intention is to add ESG to an existing investment objective/strategy
  - Maintain documentation (e.g., books and records)
    - Formalize and memorialize the steps taken to reflect the ESG considerations incorporated into the asset manager's business
- Investor Relations Considerations
  - Engage with allocators and prospective investors
    - Due diligence process
      - Initial investment
      - Ongoing monitoring
      - Respond to DDQ inquiries
    - Side letter requests
    - Consult with Legal/Compliance and certain other areas of the Firm

Key Considerations for Asset Managers

- Proxy Voting
  - A registered investment adviser is required to have proxy voting polices and procedures
  - Proxies may be voted to reflect ESG principles
  - Proxy voting policies will need to be reviewed and may need to be amended to reflect how the manager intends to incorporate ESG into its voting decisions
- Corporate Engagement
  - ESG-specific questions during standard diligence
  - Letters to the company’s board of directors
  - Meetings with company management
  - Shareholder proposals
  - Proxy solicitation campaigns

Key Considerations for Asset Managers

Considerations for Registered Investment Companies (RICs)

- Higher levels of scrutiny and oversight
    - SEC staff review
    - Fund board oversight
- Sub-Advisers
- Shareholder advocacy
    - Transparency of proxy voting
        - Fund proxy voting policies and procedures and proxy voting records are publicly available
        - Fund engagement on ESG issues
        - Increased focus on how funds are voting proxies
- Fund name
    - Names Rule

Key Considerations for Asset Managers

Considerations for Asset Managers Raising Capital from ERISA Fiduciaries

- ESG vs SRI & ETI
  - Modern portfolio theory
- Plan Fiduciary Considerations
  - ESG-dedicated funds
  - Investment horizon
  - Investment opportunities
- Manager Considerations in a Non-Plan Asset Fund
  - Articulated investment thesis as to: (i) what ESG factors are considered and (ii) why these ESG factors should lead to comparable over the investment horizon

Key Considerations for Asset Managers

- ERISA Fund Considerations
  - Considering ESG risks and rewards
  - ESG factors are impacting share price
  - ESG is a consideration in the investment process, but cannot be determinative
  - ESG considerations do not limit the universe of available investments

The Future of ESG

- Coalesce around common standards and definitions and the further development of the service provider ecosystem
- Increased focus by allocators on a manager's use of ESG factors in its investment process
- Potential for increase in ESG corporate engagement
- Effect of global regulatory focus
- SEC staff guidance/risk alert(s)

S. John Ryan

Summary

S. John Ryan is a partner in Seward & Kissel's Employee Benefits Group. He joined the Firm in 1998.

John advises a variety of clients — publicly and closely held corporations, partnerships, governmental entities, tax-exempt foundations and sole proprietorships — concerning all aspects of employee benefits matters. These matters include representation involving the structuring, drafting, operation, amendment and termination of qualified and non-qualified pension, profit-sharing, stock bonus and employee stock ownership plans, individual retirement accounts, stock option plans and group life, disability, medical reimbursement, and other types of welfare plans.

John has particular expertise with the fiduciary aspects of ERISA. He regularly assists clients in developing investment products for the pension plan market, tailoring investment products for specific plan investors and analyzing the fiduciary duties, and prohibited transaction risks imposed by these investment structures, specific investment agreements or potential transactions on money managers.

Debra Franzese

Summary

Debra is a partner in the Investment Management group. She works with sponsors and managers of various private investment funds and other pooled investment vehicles, including hedge funds, private equity funds, funds of funds, commodity pools, co-investment vehicles and various “hybrid” funds. In particular, Debbie focuses on fund formation and structuring, the offering of interests by private investment funds, and the negotiation and documentation of such investments. Debbie has experience in organizing both domestic and offshore partnerships and other investment vehicles, including separately managed accounts established for institutional investors. She has significant experience advising clients regarding regulatory and compliance matters, including the availability of exemptions from registration for both U.S. and non-U.S. investment advisers, the development of compliance policies and procedures, the completion of regulatory filings, and assistance with regulatory examinations. Debbie also represents investment advisers in connection with seed-capital investments and side letters and represents funds of funds and other institutional investors in connection with their investments in private funds. She has also assisted clients with the completion of non-U.S. regulatory filings, including those required in connection with AIFMD.

Debbie received a B.A. from Stockton University, summa cum laude, and her J.D. from American University, Washington College of Law, magna cum laude.

Lancelot A. King

Summary

Lance King is counsel in Seward & Kissel's Investment Management Group and is located in the Washington, DC office.

Lance's practice focuses on a broad range of regulatory, compliance, and transactional matters affecting investment companies and registered investment advisers. His experience includes counseling clients in the establishment, registration, and operation of registered investment companies; developing and reviewing compliance programs for investment companies and investment advisers; and counseling clients undergoing regulatory examinations.

Lance previously served as assistant vice president and associate general counsel at an investment management firm that has been a leader in responsible investing. His responsibilities included the preparation of disclosure and regulatory filings, the review of mutual fund advertising, and drafting and reviewing contracts with service providers. He formerly held Series 7 (General Securities Representative), Series 24 (General Securities Principal), and Series 53 (Municipal Securities Principal) FINRA licenses, and earned the Claritas® Investment Certificate from the CFA Institute.

Lance received a B.A. from Tufts University and a J.D. from the University of Pennsylvania Law School.

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